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Editors' Corner

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# Building Impact Businesses through Hybrid Financing

**Abstract:** The paper shows how social enterprises can be funded efficiently, and in ways that are compatible with their underlying business models, by combining both grants and different forms of investment capital. Financial sustainability remains one of the most pressing issues facing the social enterprise sector, despite rapid development over the past few decades. The paper sheds light on select funding instruments revealing how hybrid financing strategies can enable and enhance the organic growth of social enterprises and drive greater impact.

**Keywords:** social entrepreneurship, hybrid financing possibilities for social entrepreneurs, efficient funding of social enterprises, effective use of different pools of capital, impact investing

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## Introduction

Around 1 billion people go to bed hungry every night and over 2 billion do not even have access to something as basic as a toilet. We are hitting the limits of our open-loop economy, which is using up resources beyond the planet's carrying capacity, a point illustrated by intensifying levels of $CO_2$ emissions. The complexity of the current situation cannot be understated, particularly with the evolving politics of the Middle East following the implosion of entire countries in the aftermath of the Arab Spring, the recent fallout between the West and Russia, and the advent of an era of cheap energy made possible by the large-scale adoption of fracking in the United States. The expected convergence between most developing countries and the advanced economies has not

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materialized. As a result, fresh ideas are needed to master the many challenges facing the world, as are equally clever ways to go about implementing them.

Social entrepreneurship is becoming an important driver of global change and of the transformation of capital markets. While often perceived as incredibly unique, the generation of the social entrepreneur is similar to its predecessors in one important way: every generation seeks to define its place in history. Generation Y (i.e. also known as the Millennial Generation or people born between the 1980s and early 2000s) is gradually ascending to positions of authority, and is attempting to provide the world with new and innovative solutions to ongoing global problems. A number of social entrepreneurs have managed to create fairly large social enterprises since the concept first made its appearance in the early 1980s, illustrating in the process that markets can be reconciled with positive social outcomes, especially in developing countries.

Yet it is important to keep in mind that while the social sector is large and growing, several issues limiting its ability to contribute societal progress remain, including a high level of fragmentation and a lack of accessibility for talent. Accordingly, this article focuses on two core concerns that every social entrepreneur has encountered at some point: deciphering the most effective ways to (a) fund a social enterprise efficiently and (b) use different pools of capital effectively.

In order to untangle the spectrum of capital, this article will first define the concept of social entrepreneurship in more detail. It will then highlight recent experiences associated with impact investing. The paper will also tease out the implications of hybrid financing possibilities for social entrepreneurs; including forms of financing that seek a financial return and those that do not, and their combination (i.e. an arrangement also called “hybrid financing”). Furthermore, the article briefly discusses the experience of microfinance and emphasizes the dangers of engaging in commercial capital markets without carefully considering the implications of single bottom line funding for mission-driven enterprises by explaining one of the most high-profile social impact disasters of the past few years. Finally, this article outlines how the different hybrid funding instruments can be used to build and effectively finance the much needed social enterprises of the future.

## 1 Grasping the Full Potential of Social Entrepreneurship

Social entrepreneurship is not a new phenomenon. In fact, social entrepreneurship is a perennial phenomenon defined as combining existing resources in novel ways that yield added social value: there have always been individuals throughout human history who have found innovative ways to fulfill social needs. As understood today, however, social entrepreneurs typically use market mechanisms to (a) deliver a good or a service in a highly effective fashion to a marginalized or poor population that otherwise would not have the same level of access to the good or service, or (b) provide access to opportunities and income to a disadvantaged community. The notion of social value is central to this concept. Rather than seeking to maximize profit, a social entrepreneur aims to optimize social impact. Their ideas are now present in many areas, including companies that look beyond marketable corporate social responsibility and actually seek real engagement with communities and business innovation; philanthropists who aim to be catalytic with their limited resources; and governments that promote social entrepreneurship to achieve cheaper or more effective provision of public goods.[1]

While social entrepreneurship has proven to be a successful way of coming up with innovative solutions to global issues, the financing of social enterprises remains a major issue. Philanthropic donations were traditionally the primary source of funding for social entrepreneurs, despite their promotion of market mechanisms. Yet the sources of funding have become more diverse as the field has grown and matured. Social entrepreneurs increasingly access different types of financing over the lifecycle of their work. The progression typically begins with seed grants and progresses to layers of risk capital through equity and debt. In pursuing such hybrid financing strategies, social entrepreneurs mirror long-term trends that are reshaping our global economy and society. We define hybrid models of financing for social entrepreneurship as providing financing via a variety of financial instruments. The demand for such models was echoed recently by Chris West, the Director of the Shell Foundation and a longtime supporter of social enterprises, when he commented, "one of the barriers social enterprises face in reaching scale and sustainability is the 'valley of death' that exists between securing grant funding and investment capital. To bridge this gap, we see the need for innovative tiered capital structures that blend both 'patient capital' with debt and equity."[2] Patient (i. e. long-term capital) is needed, as is grant funding, provided social entrepreneurs use market mechanisms and entrepreneurial methods to provide goods and services to the poor or to otherwise disadvantaged communities.

The financing needs of social entrepreneurs can be classified based on whether they are public or private good providers. Given the lack of clarity

**1** On the role of governments in the social enterprise/impact investment space, see also the report prepared for the inaugural G8 Social Investment Forum in 2013: Martin (2013); on the role of companies who can engage via impact-oriented corporate venture capital, see also Martin (2014).

**2** Communication to the author, May 20, 2014.

regarding the concept of social entrepreneurship, it is important to know that these entrepreneurs can be segmented further according to the fundamental viability of their business models. A grantor or investor can divide potential funding targets into two broad categories:

- *Social entrepreneurs who provide public goods*. These are typically mission-driven not-for-profit organizations that create mainly social or economic benefits that cannot be monetized in markets for goods and services. In their core activity, these entrepreneurs depend on grant funding. Dependency on grants may, however, decline in the medium term to the extent that economic benefits such as government expenditures become monetized through payments linked to performance that feed into monetary returns via contingent returns models, such as so-called social impact bonds or development impact bonds, which are discussed below.
- *Social entrepreneurs who provide private goods*. These are typically mission-driven for-profit or not-for-profit organizations that create both social and economic benefits, and whose business models are financially sustainable or even profitable. They typically begin with grant funding and can transition to other forms of funding once they reach critical mass, sourcing forms of capital that require repayment and/or a financial return.

Private good social entrepreneurs are generally more prone to benefit from receiving hybrid funding than their public good counterparts. There are two interesting subcategories on this commercial border of the public–private good social entrepreneurship continuum, including:

- *Microfinance institutions*. Microfinance institutions (MFIs) are the most advanced and controversial subfield of social enterprise. Operating in the financial sector, they create both economic and social value. MFIs range from very small non-profit associations that are classified as social enterprises to large commercial banks that cannot automatically be referred to as social enterprises. In their genesis, they share a mission to serve the poor by extending very small loans and other products to either the unemployed, poor entrepreneurs, or to others living in poverty that are deemed non-bankable. MFIs can be incorporated under a variety of different legal statuses, including foundations, cooperatives, credit unions, non-bank financial institutions or fully fledged banks. In the discussion, we treat MFIs as a distinct sector because of its sheer scope and scale. Methodologically, however, MFIs are one component of the aforementioned group of social enterprises that provide private goods and services.
- *Small and medium enterprises (SMEs) with a demonstrated social impact*. SMEs are another group of ventures on the margins of private good social

entrepreneurship. SMEs are typically for-profit companies that create both social and economic benefits.[3] For example, they may offer jobs in particularly depressed areas or produce goods and services that carry positive externalities. Whether SMEs are in fact social enterprises or mainstream commercial SMEs depends on their choices in handling eventual tradeoffs between the creation of social and economic value. An additional criterion is the degree to which profits are reinvested in the venture to enhance its ability to serve and enlarge its circle of clients. Clients may become small-scale entrepreneurs rather than employees, creating economic empowerment and a growing pool of capabilities for further innovation and replication.

## 2 What Does the Rise of Impact Investing Mean for Social Entrepreneurs?

New and established social entrepreneurs are increasingly becoming aware of the fact that the use of hybrid financing strategies at the level of individual social enterprises coincides with the rise of impact investing – defined as investments made with the intention to generate measurable social and environmental impact alongside a financial return – affecting the ability of firms to mobilize capital.[4] Globalization, long-term demographic trends, changing consumer preferences and the state of public finances are collectively driving the emergence of an integrated social capital market for the first time in human history that targets both financial return and social impact. Unlike mainstream capital markets, a key component of the funding associated with the new social capital market is the combination of grant funding and a variety of debt and equity instruments, using the former to reduce risk and enable the use of the latter.[5] Forecasts have been massive in terms of expected volumes allocated

3 SMEs are typically in the real sector. The “real sector” refers to economic activity in the primary (agriculture), secondary (industry) and tertiary (services) sectors, except financial services.

4 See “About Impact Investing,” Global Impact Investing Network, accessed May 19, 2014. http://www.thegiin.org/cgi-bin/iowa/resources/about/index.html.

5 The world’s social capital market is already large and growing: Germany’s social spending alone exceeds EUR 647 billion a year (OECD 2014); around the world in 2012, high net worth philanthropy allocated approximately USD 300 billion per annum (Bank of America 2014); charities around the world command assets in excess of USD 2.57 trillion (National Center for Charitable Statistics 2014); and the US government grants in excess of USD 137 billion a year to non-profits for services (Pettijohn et al. 2013).

through this new investment style. In 2009, Monitor estimated that the for-profit segment of the so-called impact investing market could grow to USD 500 billion over the next 5–10 years.[6] A report published by JP Morgan 1 year later estimated a potential of up to USD 1 trillion for impact investments by 2020, assuming appropriate funding and scaling of existing business models targeting Base of the Pyramid (BoP) populations.[7] The most current market estimate was published in 2014 by J.P. Morgan and the Global Impact Investing Network (GIIN) and indicates current impact investment assets of USD 46bn among its members.[8]

While the concept of impact investing was coined only in 2007, the amount of quantitative market studies, not to mention meta-level discussion, on accelerating the emergence of the impact investing industry is staggering, paired with a lively discussion underway about its "real" potential – questions whether impact investing is a scam or a golden opportunity. Felix Oldenburg, Director of Ashoka Europe, published an article entitled "The Dangerous Promise of Impact Investing."[9] In it, he argued, "the promise of channeling vast funds to social causes through impact investing actually does more damage than good [...]. Great social entrepreneurs look for the fastest way to change the system with the cheapest form of funding available – not for the safest way to produce surpluses to pay back expensive loans or mezzanine capital."[10] In Oldenburg's view, business models that can create profit surpluses will not become the mainstream of social change work. Denouncing impact investing as "hype" sparked a lot of controversial discussion in the social entrepreneurship and impact investing fields. Miguel Granier, the founder of a US-based impact investment firm, argued in response that philanthropic funding and investment financing are fully complementary. According to Granier, "for-profit social enterprise and impact investing do not limit social impact by taking away dollars from the 'idea'. Rather, impact investing is a new asset class with conservative estimates predicting USD 400 to USD 1000 billion worth of new impact investments over the next ten years."[11] We need to ultimately look at outcomes in order to assess the real potential of impact investing, and give this emergent investment style time to prove what it can do.

**6** Monitor Institute (2009).

**7** For further information, see JP Morgan Global Research (2014), the Rockefeller Foundation and the GIIN, 2010.

**8** Saltuk et al. (2014).

**9** For further information, see Oldenburg (2011) and the reply: Michel (2011).

**10** Ibid.

**11** Saltuk (2013).

The overall impact investing story will certainly need more time to fully unfold. Nevertheless, what do these initial successes with impact investment mean for social entrepreneurs? In developing countries and emerging markets alike, social entrepreneurs target the economically active poor and disadvantaged who suffer from pent-up demand and market structures that cause, and perpetuate in some cases, disadvantaged access to affordable goods and services or inhibit the productive use of the capabilities of poor or marginalized populations. Key factors include entry barriers, lack of information, imperfect competition, insufficient vesting of property rights as well as high search, transaction and switching costs. These variables have caused commercial markets to neglect the needs and potential of poor and disadvantaged populations. These neglected markets are often referred to as the "Base of the Pyramid" (i.e. also "Bottom of the Pyramid," abbreviated as "BoP").[12] Social entrepreneurs engage in a large span of activities that provide access to goods and services to the BoP. These activities range from basic goods (e.g. agriculture, housing, water and sanitation) to services (e.g. education, energy, health and financial services) that meet fundamental human needs. Grant funding and investments in this context help to facilitate job creation, energy efficiency, asset accumulation as well as the inclusion of BoP or disadvantaged suppliers in global value chains. The resulting economic and social empowerment of the end clients means that, in principle, many of these goods and services could be provided at a profit, while still achieving goals related to social transformation. Moreover, new BoP products and services could be a source of reverse innovation and ultimately lead to new and compelling products and services in wealthy countries as well.

Investors increasingly see the BoP as a significant debt and equity investment opportunity as a result, one that combines considerable social impact with positive financial returns. Because of their double (or triple) bottom lines (people–planet–profit), social enterprises represent a more complex business model than ordinary commercial businesses. Their lead times for reaching the capital stage – which is when they achieve sufficient scale to cover their costs, grow to full scale and become replicable – are generally longer.[13] Profitability tends to kick in only once strong volume growth has been achieved because unit margins on products destined for the BoP are generally lower. Moreover, the widespread expectation of lower social enterprise profitability compared to commercial enterprises calls into question the classical venture capital model. If we cannot expect a few highly profitable exits to cross-subsidize the risk-taking inherent in

12 Prahalad (2004).

13 We define capital stage as expansion phase (i.e. the scale-up of business operations through resources), infrastructure and human capital investment.

funding a portfolio of ventures (many of which will never take off and will not return risk capital to shareholders), we need to find new investment models and methods for taking cost out of the due diligence process without undercutting its predictive power.

## 3 Financing Social Entrepreneurs Working in Public Sector Domains

For a social entrepreneur active in fields that used to be the exclusive domain of governments, impact investment, and the prospect of mobilizing private capital for public good provision with greater effectiveness, is particularly relevant. The worrying trends in public debt are intensifying the need for creative private initiatives to supplement traditional government programs in a variety of social services, which is creating room for hybrid funding models for social entrepreneurs.

A recent phenomenon – the so-called Social Impact Bonds (i.e. SIBs, also referred to as "Pay for Success Bonds," "Social Benefit Bonds" or "Payment by Results" schemes) – makes the provision of payment face an efficacy test.[14] SIBs are financial instruments that tie social service payments by government agencies to the achievement of predefined performance targets by a social agent in select social areas. In other words, SIBs are based on a contingent-return model whereby achievement of predetermined social outcomes unlocks a financial return. The "bonds" issued to prefund the build-up and growth of social programs pay a return to investors based on the size of performance payments that the relevant government agency makes to the social service provider. These services, if successful, then create both an important social value and cost savings for the public sector, while investors receive a financial return determined as an agreed-upon percentage of these same savings.

After the start of the first SIB pilot in the Peterborough prison in the UK, which focuses on reducing recidivism rates among former inmates, the idea of SIBs caught on. Time will tell if this instrument of capital allocation will help drive significant social progress or not; there are currently more than 100 pilots

**14** For further information, see Social Finance, "*Social Impact Bonds: Rethinking Finance for Social Outcomes*", 2009; Social Finance, "*Towards a New Social Economy: Blended Value Creation through Social Impacts Bonds*", 2010; Maximilian Martin, "*Four Revolutions in Global Philanthropy. Impact Economy Working Paper 1*", *Impact Economy*, 2011, accessed on April 14, 2014, URL: www.impacteconomy.com/four-revolutions-global-philanthropy.

underway around the world. Attempts are now also being made to apply the contingent return idea to social issues in developing countries, resulting in a series of so-called Development Impact Bond pilots or "DIBs."[15] SIBs can help to increase the efficacy of social programs and provide governments with a way to do more with less because they offload risk to private investors, provide incentives for continuous improvement, and create greater transparency about the link between inputs and outcomes. This structure can create win–win situations for government agencies seeking to reduce costs, and private investors wanting to invest with impact. Provided the first batch of pilot implementations is successful, designing bespoke financial instruments that value externalities and innovation has the potential to significantly change how social programs are funded and carried out.

With respect to the original pilot, though, enthusiasm has been somewhat tempered recently. First, the Peterborough pilot is to be replaced by 2015 via a new UK government program seeking to transform rehabilitation in 21 parts of the UK, including Peterborough, by having private contractors run rehabilitation services, signaling the sensitivity of new financial solutions to shifting policy environments.[16] Second, released in August 2014, the reduction in reoffending rates of the first cohort (i.e. consisting of roughly 1,000 offenders) by 8.4% over the national average was better than the minimum requirement of interventions having to be successful at reducing the number of reconvictions (i.e. the number of times within 1 year an offender is convicted by a court of a follow-up offence) by 7.5% over the course of two cohorts; but it failed to meet the 10% threshold over either one of the cohorts that would have triggered a success payment for impact investors right away.[17]

## 4 Scale and the Dangers of Capital Markets: The Example of Microfinance

When ascertaining how financial innovation can help social enterprises to achieve social impact, the experience of microfinance is for many the blueprint for the sophisticated use of financial instruments. It also has been responsible for one of the most high-profile social impact disasters in recent years.

**15** See Center for Global Development and Social Finance (2013).
**16** See Guardian (2014).
**17** Ministry of Justice and The Rt Hon Chris Grayling MP (2014).

Founded by Indian-American social entrepreneur Vikram Akula, SKS Microfinance Limited (SKSM: Natl India; hereinafter "SKS") was the first MFI listed on a stock exchange in Asia. SKS initially inspired admiration for its ability to rapidly scale its microfinance offering. Subsequently, though, the enterprise generated a high level of criticism surrounding its role in the recent Indian microfinance crisis that followed the firm's initial public offering (IPO) on India's National Stock Exchange, which had fueled SKS's rapid growth. Seventeen of SKS's clients committed suicide in 2010. The tragic incidents were attributed to these clients believing that suicide was the only way out of their own over-indebtedness given aggressive loan collection practices. This led to large-scale condemnation by the media, reflected in one of the headlines at the time: "30 Suicides in India Linked to Uber-Aggressive Microfinance Organizations."[18] In 2010, the Andhra Pradesh law was instituted to protect borrowers by banning doorstep collections, altering loan recollection time periods and requiring MFIs to receive government approval to give additional loans to a borrower.[19] The state law forced the firm to exit the state, which made up close to 30% of its business at the time, leading to a 72% slump on its loan book.[20]

The fallout has had wide-ranging implications in terms of social impact. Andhra Pradesh was once the focus of microfinance in India, but delinquent loans and unemployment grew as 35,000 people in the microfinance industry lost their jobs between 2010 and 2013 when MFIs responded to new regulation and scaled back their activities in the state.[21] Unfortunately, unscrupulous informal moneylenders who charge between 160% and 250% interest per annum have filled the vacancy of MFIs in Andhra Pradesh, which has partially been due to the Andhra Pradesh law.[22] The crisis has also taken a toll on SKS itself. Between 2010 and 2013, SKS' market capitalization plummeted by 91%, amid rampant criticism of criminal loan collection practices.[23] However, by Q1 2014, SKS had reported five consecutive quarters of profits, after seven quarters of losses.[24]

The goal here is not to single out any particular organization for criticism. Rather, the situation generates important implications concerning what we can

**18** Katya Wachtel (2010).
**19** Unnikrishnan (2013).
**20** Bandyopadhyay and Unnikrishnan (2013).
**21** Unnikrishnan (2013).
**22** Chakraborty and Sokhi (2012).
**23** Bandyopadhyay and Unnikrishnan (2013).
**24** SKS Microfinance India (2009).

learn to avoid such experiences in the future. The episode points to the importance of critically assessing the relationship between MFIs and the rural poor, and the constructive use of capital markets and consumer protection legislation. Social entrepreneurs who are now building or scaling their businesses are well advised to think through the implications of patterns of overexpansion followed by withdrawal for their clients.

SKS is an instructive case with respect to the prospects of hybrid funding strategies because it got started with grant funding and later moved into other forms of financing before it became publicly listed. While initially viewing itself as an agent of change, SKS has since reconsidered the consequences of the company's profit motive. A 2013 interview with M.R. Rao, the CEO and managing director of SKS, and S. Dilli Raj, the CFO of SKS, holds lessons for anyone who starts out as a social entrepreneur and aims to use mainstream capital markets to fund business growth. While acknowledging the benefits of operating SKS as a for-profit model whose primary goals are to achieve scalability and operational sustainability, Rao and Raj note that SKS must tone down its message of "empowering the poor" and the "eradication of poverty," among others:[25]

> The first mistake was all of us started as non-profit organizations and we embraced a for-profit model for good reasons – to achieve scalability and sustainability. What is the point in doing some good for some people if you can do more good for more people? But we should have discarded the larger-than-life claims and mission statements like empowering the poor and eradication of poverty when we embraced the for-profit model. The for-profit model doesn't go with this. When we had our initial public offering, people looked at our numbers, portfolio size and, most importantly, the individual incentive system like the ESOPS (employee stock options) and the salary levels. They were all relevant for a mainstream for-profit operation but the claim of eradicating poverty did not gel with that.

## 5 Using Hybrid Funding Instruments to Drive Growth

Navigating the impact investing space can be a challenge for the entrepreneur who is busy building a social enterprise. It is important to keep the estimates of market growth in perspective. A variety of financial instruments exist with different levels of risk, liquidity, time horizon, cost and ease of deployment. In pursuing external financing strategies, social entrepreneurs can in principle combine the following financing instruments and create tiered capital

25 Bandyopadhyay and Unnikrishnan (2013).

structures: grants, debt capital, equity capital and mezzanine capital. The mix of instruments that are applicable at any given time depends on the social enterprise's legal form, business model and state of maturity.

The following four definitions of the different hybrid financing instruments are meant to provide guidance for social entrepreneurs looking elsewhere for their funding. One ought to keep in mind that it is important to apply the different financing instruments in the toolbox – grants, equity, debt and mezzanine – with great diligence and in ways that are fundamentally compatible with the underlying business model of the social entrepreneur in question.

- *Grants* are defined as funds disbursed by one party to another party without any expectation of repayment. Grantmakers are typically government agencies, charitable foundations and trusts or private sector entities. Recipients are often non-profit entities and educational institutions, but can also be individuals and businesses. Today, grants remain the most widely practiced model of financing social entrepreneurs. In spite of the advantage of providing capital at zero cost, there are important limitations to grant funding. First, grants are typically project specific. They exclude overhead and business development costs, and do not provide full internal capital allocation flexibility. Second, grants typically face a limited 3–5-year time horizon, are costly to raise – estimates range from 22% to 43% of the amount raised – and project specific.[26] They are very valuable to get started, but cannot typically accompany the rising capital needs a social entrepreneur faces as the enterprise goes to scale.
- *Debt capital* is defined as capital that is raised by taking out a loan. The loan is made to the social enterprise, with the expectation to be repaid at some future date. Unlike in the case of equity capital, subscribers to debt capital do not become owners of the social enterprise, but remain creditors; debt capital is therefore an especially important source of external financing when social enterprises are structured as non-profits. Suppliers of debt capital usually receive a contractually fixed annual, or in some cases floating, percentage-return on their loan. They provide capital on a temporary basis, with repayment due after a few years. The interest on debt capital must be repaid in full before any dividends are paid to any suppliers of equity. From a business development perspective, debt capital is an attractive option whenever (a) long-term investments with stable and predictable cash flows need to be funded, (b) if the social enterprise is fundamentally creditworthy and (c) able to make an annual interest payment. Considering that risk capital is typically required to take on debt and provide layers of

**26** See Meehan, Kilmer, and O'Flanagan (2004).

risk, non-profits who cannot take on equity may need to raise grants that perform the layered risk function of equity. Moreover, in the event of bankruptcy, debt capital providers may have far-reaching rights on the assets of an organization.

– *Equity capital*, also referred to as shareholder equity or risk capital, is the residual claim or interest of the most junior class of investors in assets, after payment of all liabilities. This means that if valuations on assets exceed liabilities, equity is positive. Equity capital is an attractive external financing option for social enterprises structured as for-profit entities (thus able to accommodate shareholders) to fund activities that are necessary to scale the venture, but have an uncertain payoff or income generation schedule. Unlike in the case of debt, equity does not have to be repaid. Shareholders bear the full risk of the operation, in exchange for certain control rights. In the event of bankruptcy of the social enterprise, all secured creditors are first paid against proceeds from assets. Subsequently, creditors ranked in priority sequence can exercise the next claim on the residual proceeds. Shareholder equity is then the residual claim against assets, which is paid only after the demands of all other creditors have been satisfied. Access to such risk capital is essential to scale most social enterprises. In exchange for a certain share of the company, the investor receives a share of the future profits generated by the social enterprise, rather than regular annual payments. Given the inherent riskiness of equity, investors also receive certain control and voting rights. The rights depend upon the share held in the social enterprise and the legal framework in the country where it is registered. This means that social entrepreneurs need to carefully consider whether the "DNA" of an equity investor is compatible with the values and philosophy of the social enterprise.
– *Mezzanine capital* or *convertible debt* is a combination of debt and equity capital. It can be a useful alternative or complement to other funding sources, or if pure equity or debt capital cannot be accessed. Mezzanine instruments refer to either a subordinated debt or a preferred equity instrument that represents a claim on a social enterprise's assets. This means that repayment is required and ownership goes undiluted. The interest payment can be linked to the profits of the company whereas the total amount is repaid after a certain time period. Mezzanine financing is senior only to common shares and can be structured as unsecured debt or preferred stock. Given its higher risk, mezzanine capital is typically a more expensive financing source.

Given a clear understanding of the different possibilities, it is vital to acknowledge that the final dimension that plays into a hybrid funding model is time.

Hybrid funding models can be *synchronic*, combining grant and non-grant sources of capital simultaneously to fund the joint expansion of profitable and unprofitable elements of the value chain. This results in tiered capital structures. Or they can be *diachronic*, with hybrid funding unfolding over time, typically beginning with grant funding and then "graduating" to equity and debt funding as the venture achieves critical mass. This is the typical transition path for most private good social entrepreneurs in microfinance, BoP social enterprises and beyond.

## 6 Conclusion: Financial Innovation as a Catalyst for the Social Enterprises of the Future

As mentioned, social enterprises encounter multiple challenges in building the scale required to make a significant impact on the large-scale issues facing the world, with access to capital often being the binding constraint. It can be concluded that successful social enterprises often use diachronic hybrid financing, either opportunistically or in a preplanned, strategic fashion. Grants remain the best way to seed fund a social enterprise, but if the venture achieves initial success, grants tend to become insufficient in providing the capital required for the venture to scale at some point. Overdependence on grants can then effectively establish a glass ceiling for impact because social entrepreneurs need to focus most of their time on fundraising rather than on the development of their ventures.

Whether synchronic hybrid financing makes sense or not depends on the specific problem the social entrepreneur is trying to solve, as well as the ability to distinguish and delimit the different elements of the organization's value chain. In the BoP and the industrialized world alike, the specific combinations differ depending on the type of social venture considered: public or private good social entrepreneurship. Public good social enterprises require grant and technical assistance funds, but typically little (to no) debt or equity for fueling core businesses. Private-good social entrepreneurs typically prosper from a combination of debt and equity capital, paired with technical assistance and capacity building grant funds. This is most obvious where social entrepreneurship borders on commercial entrepreneurship, as in the case of microfinance and SMEs.

In the industrialized world, a key question aspiring social entrepreneurs will have to resolve is how to engage the public sector in hybrid funding, especially since the government has had such a significant presence in the provision of public goods. A case is building for hybrid models that involve public sector funding whenever social entrepreneurs have provided proof of concept of a more efficient solution but where there are barriers to scale and replication, and when capital markets can be used to raise risk capital for scaling and replication and to monetize grant commitments. These scenarios include (a) whenever addressing a problem now is cheaper than addressing it in the future when the grant commitment is actually paid out, allowing for financial engineering; (b) when new market places need to be constructed or (c) when the most efficient solution provider is not a government agency. The SIB mentioned earlier is just one of several possible conduits of private risk funding to unlock government resources upon "payment by results" (i.e. the achievement of a social outcome).

While we could not possibly claim that managing to keep an additional 84 former inmates out of trouble in the UK Peterborough prison pilot alone provides a sufficient empirical foundation to assess the overall viability of a potentially powerful new funding model, looking at the public financing gap in a number of fields makes it clear that the scope for financial innovation is significant. A recent study by Accenture and Oxford Economics projected a public services expenditure gap between expected demand for services and the ability to pay through the year 2025.[27] The results were startling: for Canada, the gap was USD 90 billion; France, USD 100 billion; Germany, USD 80 billion; Italy, USD 30 billion; the UK, USD 170 billion; and the US, USD 940 billion. Private capital will be critical to addressing this emerging gap, as will new solution providers such as social entrepreneurs; intentionally investing for both social impact and financial return can provide a way to engage that capital.

This article focused mostly on the use of hybrid financing models to unlock the full potential of a social enterprise to serve the pent-up demand for its solution. But clarity about hybrid funding strategies in the field of social entrepreneurship is also relevant at the level of the investment vehicle. The experience of microfinance shows that to operate with reasonable scale and risk characteristics, most for-profit social investment opportunities require some kind of philanthropic capital. This can be in the form of technical assistance and capacity-building grants, or of first-loss commitments or loan guarantees that create tiered capital structures, transforming junk paper into investment grade.

At a time when the business of social entrepreneurship is booming, and the world is in need of smart solutions now more than ever before, understanding the true potential of hybrid financing strategies to help build impact businesses plays an important role in accelerating the development of the field of impact

**27** Accenture (2012).

investments, and in building, and financing the social enterprises of the future. The proposition is ultimately very simple: we cannot expect to build a better industry if we do not manage to fund the underlying ventures efficiently. Social entrepreneurs who are now creating or scaling their ventures are therefore well advised to assess how a hybrid use of financial instruments can advance their funding and business development goals, and to pre-plan for likely discontinuities that are affecting the world of social enterprise such as the ongoing information revolution and financial innovation.

A lot remains to be done. But we can expect the overall rising skepticism toward mainstream capital markets, paired with increasing government debt and a private sector progressively looking for win–win social-business opportunities to give social entrepreneurs a big hand as they apply state-of-the-art approaches to create both economic and social value. Members of Generation Y are more technologically savvy than the Generation Xers or Baby Boomers that are preceding them. They also appear more detached from institutions, as well as more networked with friends than previous generations around the world, regardless of their location and ethnicity. Over time, we will find out whether their contribution to history will be mainly civic, helping to build the strong communities at both the local and global levels now needed, or whether they will be remembered as Generation Me, characterized by narcissism and a sense of entitlement, navigating the Titanic closer to the iceberg.

Albert Einstein famously remarked, “If I had only one hour to save the world, I would spend fifty-five minutes defining the problem, and only five minutes finding the solution.” One thing is certain: new Generation Y social entrepreneurs and their older Generation X colleagues who want to build high-performing ventures can benefit from a sophisticated approach to deploying the various pools of capital potentially available, and thus turbocharge building impact businesses which systematically align making profit with the creation of positive social and environmental impact at a scale where it makes a difference justifying the effort.

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